Position paper

Internal Auditing in Europe

- February 2005 -

European Confederation of Institutes of Internal Auditing

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Yves Chandelon
President of the ECIIA

Foreword

The business and financial communities have their sights firmly set on improving corporate governance and risk management, following the recent fallout from high-profile corporate scandals. Non-governmental and professional bodies have responded positively by providing recommendations aimed at restoring public trust and confidence to corporate life. In addition, political and legislative initiatives are underway worldwide.

The Internal Market Directorate of the European Commission has proposed a new Directive on statutory audit (the 8th Directive) and is working to implement its action plan, "Modernisation of Company Law and Enhancement of Corporate Governance in the European Union - A Plan to Move Forward". The European Confederation of Institutes of Internal Auditing (ECIIA) is taking this opportunity to highlight how the professional practice of internal auditing makes a positive contribution to achieving good corporate governance and effective risk management in organisations based in Europe and beyond.

In particular, this position paper describes how internal auditing sits at the heart of these processes, not least by the promotion of the highest ethical standards among ECIIA professionals. The paper also sets out how internal auditors add value to the relationships they have with other participants in the governance process. It is hoped that these comments will be of use to the Commission in its deliberations.

The ECIIA is a confederation of 30 national associations of internal audi-

ting which are located in countries within the greater European economic area (See Appendix 1). ECIIA members are part of a global body – the Institute of Internal Auditors (The IIA). The IIA was established in 1941 and currently represents 100,000 internal auditing professionals worldwide.

All internal auditing professionals are required to adhere to The IIA's Code of Ethics and to comply with the International Standards for the Professional Practice of Internal Auditing. This ensures that internal audit work is performed by competent professionals in compliance with professional guidance and rules of conduct requiring objectivity, due professional care and periodic quality assessments.

Philippe Christelle, *Past President ECIIA (Relations with the European Commission)*

Contents

Pages

Executive Summary

Stakeholders of organisations are increasingly demanding that boards and executive management apply accepted governance principles, adhere to sound risk management and demonstrate publicly that they are in control of their organisations. This call for greater transparency and accountability will only accelerate as businesses become more technologically sophisticated and global.

Good governance requires that the board is responsible for applying high ethical standards; for guiding strategy and risk policy; for monitoring corporate performance; and for ensuring that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control. Executive management is responsible for implementing these systems.

Risk management starts with identifying and evaluating the risks the organisation faces. Then management must decide if the risks are at an acceptable level and, if they are not, take action to respond to those risks. A framework of internal controls is a key response to risk. Management operates the controls and, most importantly, should arrange to assure itself that the controls are working effectively. It can then provide management assurances to those responsible for governance.

A professional internal audit activity will support both the board and executive management in carrying out these responsibilities. It will complement management's assurance that the systems are working effectively by

providing objective assurance on governance, risk management and internal control processes. It will also advise management, facilitating improvements in these areas. Internal auditors, therefore, remain one of the most important independent checks and balances available to the board and executive management.

So, what is professional internal auditing? It is a distinct, self-regulated, global profession, represented internationally by the Institute of Internal Auditors (The IIA). The IIA was established in 1941 and currently represents a hundred thousand internal auditing professionals worldwide in one hundred and sixty countries. The IIA has codified a principles-based set of international standards for internal auditors and internal auditing - The IIA's *Definition of Internal Auditing*[1], *Code of Ethics* and the *International Standards for the Professional Practice of Internal Auditing (International Standards)*[2]. Taken together, these principles set out the prerequisites for a professional internal audit activity to exist. The members of the thirty chapters and institutes of The IIA located in the greater European region, which form the ECIIA[3], are committed to applying and upholding these standards.

The IIA's *Definition of Internal Auditing* includes references both to assurance and to consulting activities directed at the governance, risk management and internal control processes. It can, therefore, be seen that an internal audit activity that fulfils the definition is a strong position to support the board and management as an essential component of their governance mechanisms.

[1] *See section 2.1*
[2] *See Appendix 2 for the Code of Ethics and Appendix 3 for an abbreviated version of the International Standards.*
[3] *See Appendix 1*

The ECIIA recognises that, in order to fulfil this definition and, therefore, to address most effectively management objectives and stakeholder interests, a professional internal audit activity must comprise competent professionals, working within an organisation in accordance with The IIA's *Code of Ethics* and the *International Standards*. The *Code of Ethics* spell out the principles of integrity, objectivity, confidentiality and competency that internal auditors are expected to apply and uphold under all circumstances. The *International Standards* set out measures to safeguard the independence of the activity, a systematic methodology for auditors to apply in performing their duties and quality assurance requirements.

To guarantee the independence of the internal audit activity, the chief audit executive should report functionally to a body such as the audit committee and administratively at the level of the chief executive officer of the organisation. An independent, adequately resourced and competently staffed internal audit function will provide assurance on the effectiveness of the organisation's governance processes and on how well it manages all kinds of risk – operational, technical, commercial, financial and administrative. The scope of its work should not be limited geographically or by business area.

The ECIIA believes that a strong governance process is dependent on the synergy generated among the different components of the governance system: the shareholders, the board, the executive management, the statutory auditors and the internal auditors. These various participants work together to provide an effective system of checks and balances that blends internal understanding of the business with external assessments. Therefore, it is

important that there exist strong and mutual relationships between these different bodies.

More and more organizations are beginning to benefit from professional internal audit practice. This can be seen from the growing number of internal auditors in Europe that can be found in all sectors, public and private. This growth has been accelerated by legislation and regulation that requires organisations to demonstrate the effectiveness of their governance, risk management and internal control processes because it is clear that an internal audit activity is uniquely positioned to support management.

In the detailed paper, we set out what we consider to be best practice in internal auditing and how organisations should use internal auditing to help achieve good governance and risk management practice. The most important points are:

1. Professional internal auditors will apply and uphold The *IIA's Code of Ethics* in all circumstances.
2. The audit committee will ensure that the mandate and responsibility of the internal audit activity is formalised in a charter that it approves.
3. The audit committee will ensure that the internal audit activity has a direct reporting line to the chief executive of the organisation and an open and direct communication line to the board and itself, in order that it maintains its independence.
4. The chief audit executive will support the board and executive management in fulfilling its responsibilities for the systems of governance, risk management and internal control.
5. The audit committee will ensure that the internal audit activity is ade-

quately resourced and competently staffed by investing in their qualification and their continuing professional development. The promotion of qualifications, endorsed by the profession of internal auditing, will be central in this approach.

6. The chief audit executive will develop and maintain a quality assurance programme that covers all aspects of the internal audit activity, monitoring its effectiveness by using both internal assessments and assessments by appropriate external review bodies.
7. The chief audit executive will plan the internal audit work on the basis of the risks facing the organisation, will make relevant and timely reports to other participants in the governance process and will follow-up internal audit recommendations to enable the drive for continuous improvement in the organisation to be successful.
8. The internal audit activity will promote internal controls that effectively mitigate risks in all activities of the organisation.
9. The audit committee and the chief audit executive will work to improve the cooperation between all those active in the field of governance, in particular, optimising cooperation with statutory auditors to ensure the comprehensive audit of all activity.

The ECIIA urges the European Commission and other interested bodies to encourage the establishment of professional internal audit activities in privately held organisations, governmental and non-governmental institutions. All such activities should fulfil The IIA's *Definition of Internal Auditing, Code of Ethics* and *International Standards*.

1. Introduction: Internal auditing in governance, risk management and internal control

The first section of the paper describes what is meant by good governance, risk management and internal controls and summarises the key role that a professional internal audit activity will play to support the board and management in governance responsibilities.

1.1 Governance

Governance is concerned with the proper management of organisations. Although there is no single prescribed model for good governance, successful models share common elements with each other: for example, the OECD Principles of Corporate Governance deal with the rights of stakeholders; the need for disclosure and transparency of information about the organisation and the role of the board of directors. At the most fundamental level, governance is about ensuring that whoever decides the objectives of an organisation communicates them to the stakeholders and then takes actions to ensure that the activities of the organisation are directed towards achieving those objectives.

Governance has been and continues to be the subject of lively debate in Europe, Asia, Australia, South Africa and North America. A recent series of crises and collapses of reputable companies together with evidence of large-scale corporate malpractice have shaken public trust and invigorated the debate, leading to increasing legislation, regulation and other codifications of what comprises good governance.

Common features of descriptions of good governance are that the board has a major responsibility for governance and that the board has to apply high ethical standards; to guide strategy and risk policy; to monitor corporate performance; and to ensure that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control.

A professional internal audit activity will play an active role in supporting an organisation's board in achieving these elements of good governance. The activity will periodically assess the state of the ethical climate of the organisation and will test the effectiveness of the processes in place to achieve the desired level of ethical compliance. It will also review and provide objective assurance on the systems of control, including risk management and operational and financial control.

1.2 Risk management

Every person and every organisation faces risks. Economic theory teaches that investors obtain rewards by taking risks. Risks are not an evil to be eradicated. However, in order to maximise the rewards and to reduce the variability in final outcomes, those responsible for governance must identify the risks their organisations face, evaluate them, decide if they are at an acceptable level and, if they are not, take action to respond to those risks. Then they must monitor the progress of those actions and assure themselves that they are addressing the risks as required. This is risk management.

Risk management works best if it is acknowledged to be the job of every member of the organisation and is integrated into the organisation's culture and embedded in all its day-to-day and periodic activities. This makes

it a key part of the role of executive management and the best management teams have always recognised that.

Recent events have highlighted the importance of the management of risks to good governance. A comprehensive, organisation-wide approach to risk management, while not essential for managing individual risks, will ensure that the organisation achieves the maximum, sustainable benefits from its risk management efforts and that the operation and effectiveness of risk management activities can be monitored and assessed.

A professional internal audit activity will be able to support risk management in two ways. Firstly, it will provide objective assurance to the board and to management that the risk management framework as a whole is operating effectively and that specific risks are being managed to the expected level. Secondly, it will invest its time and effort in consulting activities, which contribute to the establishment of sound risk management processes across the organisation[4].

1.3 Internal controls

The purpose of implementing internal control processes is to help people manage risk and, in doing so, achieve the objectives of the enterprise.

Internal control processes are expected to ensure, among other things, that the following conditions exist:

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[4] In terms of Risk Management, a major report was released in September 2004: the COSO's Enterprise Risk Management — Integrated Framework. The framework defines essential ERM components, discusses key ERM principles and concepts, and provides clear direction and guidance for enterprise risk management (www.coso.org).

- Financial and operational information, for both internal and external use, is reliable and possesses integrity;
- Operations are performed efficiently and achieve effective results;
- Assets are safeguarded; and
- Actions and decisions are in compliance with laws, regulations, and contracts.

In fact, no well-governed organisation can exist without some form of internal controls. However, the number, nature and style of controls will differ with the type of organisation and the risks it faces. The risks will be identified as part of risk management, as described above. The internal control framework is part of the response to risks and it will cover all activities of the organisation – operational, technical, commercial, financial and administrative. It is particularly important to recognise that internal controls are not limited to accounting controls or controls concerning financial reporting.

Executive management is responsible for establishing the framework of internal controls as part of its management of risk, and for keeping it up-to-date as risks change. Management also operates the controls and, most importantly, should arrange to assure itself that the controls are working effectively by undertaking regular review activities and receiving periodic reports from their own departments. This assurance activity is an essential part of a good control framework but it is sometimes overlooked by management.

Following the recent scandals and as part of the measures to improve governance, management is increasingly being required to demonstrate that it is

fulfilling its responsibilities in relation to the system of internal control. Therefore, not only do they need to have effective controls and to be assuring themselves that they have them, they also need to be able to demonstrate these facts to third parties – the board, statutory audit and even the general public.

A professional internal audit activity will supplement management's actions by providing objective assurance that internal control processes are operating as required to manage risks to an acceptable level. It will also be able to support management by providing consulting services, facilitating management's efforts to improve the system of internal control and giving advice on the implications of organisational changes to that system.

1.4 Internal Auditing

Internal auditing as a separate profession is organised on a global basis, represented internationally by the Institute of Internal Auditors (The IIA)[5]. The IIA was established in 1941 and currently represents 100,000 internal auditing professionals worldwide in 249 Chapters and Institutes in 94 countries. The IIA and its affiliates provide education, publication, research and quality assurance services. It presents important conferences and seminars for professional development, certifies qualified internal auditors, provides quality assurance reviews and undertakes benchmarking exercises. It makes standards and guidance on internal auditing available to internal auditors, board members and executive management. It also promotes the public interest and helps define the role that the internal audit activity should play in improving governance.

[5] *For further information see The IIA's web site: www.theiia.org*

As the body responsible for the self-regulation of the profession, The IIA has codified a principles-based set of international standards for internal auditors and internal auditing - The IIA's *Definition of Internal Auditing*[6], *Code of Ethics* and the *International Standards for the Professional Practice of Internal Auditing (International Standards)*[7]. Taken together, these principles set out the prerequisites for a professional internal audit activity to exist. The members of the thirty chapters and institutes of The IIA located in the greater European region, which form the ECIIA[8], are committed to applying and upholding these standards.

According to The IIA's definition, internal auditing is " an independent, objective assurance and consulting activity … to evaluate and improve the effectiveness of risk management, control, and governance processes ". The ECIIA believes that a professional internal audit activity, meeting this definition and complying with the *Code of Ethics* and with the *International Standards*, is a key component of any governance mechanism. Various government - mandated commissions in several European countries have supported this view.

The ways that professional internal auditing can provide value to those responsible for governance have been outlined above. In summary, there are two sorts of contribution – assurance and consulting. With regard to assurance, a professional internal audit activity will complement and support management assurance by providing objective assurance on the effectiveness of the processes for achieving good governance, risk management and internal control. As part of its work, such an activity will also provide

[6] *See section 2.1*
[7] *See Appendix 2 for the Code of Ethics and Appendix 3 for an abbreviated version of the International Standards.*
[8] *See Appendix 1*

consulting services, facilitating and advising on improvements in these areas.

The next two sections of the paper will provide more details on the characteristics of a professional internal audit activity. This includes the need for it to have an independent position within the organisation and to be overseen by those responsible for governance. It will have an adequate number of competent in-house management and staff to develop and maintain an in-depth knowledge of the organisation. This number will vary depending on the size and complexity of the organisation, e.g. small organisations may find their requirements most effectively met by internal auditing resources from third party service providers, with the contract overseen by an appropriate authority, perhaps, the chief executive. These internal auditors will be committed to behaving in accordance with principles of the *Code of Ethics*, demonstrating integrity, objectivity, confidentiality and competency. The activity will apply its expertise and a systematic methodology to providing objective assurance on governance, risk management and internal control processes. It will monitor its quality and subject itself to periodic quality reviews.

2. Internal Auditing: an independent and professional activity

This section of the paper explains what a professional internal audit activity is and its attributes – how it is organised, managed and resourced and how it ensures the quality of its work on an ongoing basis.

2.1 Definition

The IIA's *Definition of Internal Auditing* states: "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes".

With the exception of certain industries such as banking, insurance and financial services, little legislation exists in European countries related to internal auditing and internal control. This is in contrast to the situation with the annual audit of an organisation's published financial statements (statutory audit). In fact, the professional practice of internal auditing is governed by a system of self-regulation, which is based on globally accepted standards, ethical principles, and other best guidance practice.

2.2 Purpose of internal auditing

The board has, among others, the responsibility for ensuring that executive management establishes, maintains, operates and demonstrates an appro-

priate framework of risk management and internal control. Executive management is responsible for identifying, assessing, monitoring and mitigating the risks that their organisation faces and for assuring themselves that these risk management processes, including the related controls, are operating effectively.

One of the key roles of internal auditing is to provide objective assurance to executive management and to the board that the risk management processes remain complete, efficient and effective. As part of this work, the internal audit activity will provide advice, coaching and facilitation services to assist executive management in carrying out their responsibilities.

2.3 Scope of internal auditing

The scope of internal auditing covers all of an organisation's activities, without regard for internal boundaries or geographical restrictions. Their work is based on the risk assessment. It encompasses the adequacy and effectiveness of governance, risk management and internal control processes in identifying and responding to the risks facing the organisation.

These include:

- financial and operational information may be unreliable, inaccurate or incomplete;
- operations may be ineffective and inefficient;
- assets, financial and others, e.g. information or people, may be manipulated or removed;
- the organisation may breach laws, regulations or internal policies; and
- the ethical culture may support illegal or inappropriate behaviour.

2.4 Organisational Independence

The internal audit activity should be independent from the activities it audits. It should also be free from interference in determining the scope of its work, in performing its duties and in communicating the results.

To guarantee sustainable independence, the chief audit executive should report functionally to those responsible for governance and administratively to an appropriately senior level within the organisation.

Those responsible for governance will be the audit committee, the board of directors, or another appropriate body. Functional reporting includes all matters related to the scope of the internal audit work from the plan to reporting of the results of the ensuing work, and will include reviewing the quality of the internal audit activity. The audit committee should safeguard internal audit independence by regularly reviewing and approving the internal audit charter and mandate. In this context, it should be consulted for hiring and firing the chief audit executive.

Administrative matters relate to the organisation's management structure; and the reporting line for them should facilitate the activity's day-to-day operations. The chief executive officer of the organisation should be the appropriately senior level for administrative reporting. In this role, he will reinforce the organisational status of internal auditing and support its unrestricted access to staff and information. In some cases, the CEO can appoint someone to whom the activity reports. However, it is important to ensure that this person does have sufficient authority and stature to achieve this role. Furthermore, the person should demonstrate an appropriate control and

governance mind-set; have sufficient time and interest to provide active support; and should understand the nature of the functional reporting line to the audit committee.

2.5 Professionalism

Internal auditing is a separate profession. It has its own knowledge, skills, behaviours, methodologies and standards. A professional internal audit activity will acknowledge and demonstrate its commitment to this fact.

Competency and skills

Internal audit professionals will demonstrate that they have the necessary knowledge and skill-set and that they undertake a programme of continuous education process that takes into account the complexity and the speed of change in today's organisations.

Each internal audit activity will need differing combinations of knowledge and skills to evaluate the governance and risk management processes within its organisation. The chief audit executive will obtain advice and assistance from outside the activity if the internal audit staff lacks a particular specialist skill or other competences needed to perform the work.

Qualified Internal Auditors

The IIA and its affiliates worldwide provide opportunities for internal auditors to demonstrate their knowledge and skills. The ECIIA recommends that internal auditors should make use of these opportunities to become professionally qualified.

The IIA provides the Certified Internal Auditor (CIA) designation. This desi-

gnation is a professional credential for internal auditing, recognised across the world. CIAs have been required to meet rigorous education and experience requirements and to pass a comprehensive certification examination tested by multiple choice questions. Once certified, CIA's are required to maintain continuing professional development.

IIA - UK & Ireland has developed a qualification, the MIIA, which addresses the specific needs of their business and professional education culture. MIIAs are required to pass an examination including a case study, essays and multiple choice questions and to demonstrate relevant experience and are encouraged to continue their professional development after qualification.

The IIA and IIA – UK & Ireland have a mutual recognition arrangement, which allows the exchange of the two designations (CIA and MIIA) in certain situations.

CIAs and MIIAs are bound by a professional code of ethics and by The IIA's Standards and they are subject to due process and disciplinary actions for violations of the Standards and the Code of Ethics.

Behaviours

Internal auditors need to act professionally and to remain motivated for an organisation to realise the full benefits that such the internal audit activity can bring to the risk management process and the quality of internal controls.

The most important principles of behaviour are covered in The IIA's *Code of Ethics*[9]. As noted above, these are integrity, competency, confidentiality and objectivity.

Objectivity is a state of mind that internal auditors need to maintain in performing their work. Among other things, it implies that internal auditors

[9] *See Appendix 2*

should not assume operational responsibilities and it requires special measures in the internal audit activity, such as avoiding potential conflicts of interest.

The IIA's *International Standards*

The *International Standards for the Professional Practice of Internal Auditing (International Standards)*[10] provide the basis for the guidance and evaluation of internal audit performance and outline the systematic methodology that will deliver objective assurance. Adherence to the *International Standards* is mandatory for members of The IIA and its affiliates and for all qualified internal auditors. By requiring internal audit work to be performed in accordance with the *International Standards*, the audit committee and the board gain additional assurance that their organisation's internal controls are adequate, which should strengthen public trust in the financial reporting system. Section 3 of this paper gives more details of the systematic methodology, included in the *International Standards*.

2.6 Quality assurance

2.6.1. The Quality Assessment (QA)

The *International Standards* require that a quality assurance and improvement programme be developed and maintained by every internal audit activity. This ensures that the scope of work encompasses all the activities in the *International Standards* and that the activity fulfils The IIA's *Definition of Internal Auditing*. The programme is designed to monitor the effectiveness of the internal audit activity and will include periodic internal and exter-

[10] *See Appendix 3*

nal quality assessments and ongoing internal monitoring that covers all aspects of the activity. It is recommended that the external quality assessments be conducted at least every 5 years.

The QA developed by the IIA is an external assessment of the internal audit department.
The end-product of the results includes an opinion on this compliance delivered by the lead auditor of the QA team, based on a structured rating process. The degree of partial compliance with individual standards, if relevant to the overall opinion, should also be expressed in the report. The end-product should also include an assessment and evaluation of the use of best practices, both those observed during the assessment and others potentially applicable to the activity and, where appropriate, recommendations for improvement.

2.6.2. Certification of Quality

In several European countries, certain organisations, in both public and private sectors, must make public reports on some aspects of their governance processes. This includes reporting on the effectiveness of internal controls. The ECIIA recognises that such organisations face specific pressures and, therefore, have specific needs.

Since the internal audit activity plays a key role in providing objective assurance on the governance, risk management and internal control processes on which these organisations report, the ECIIA suggests that more rigorous quality assurance requirements might be appropriate. This would include requiring external quality assessments to be undertaken more frequently

than once every five years. It might also be appropriate to use for those assessments a methodology that is better understood by the users of the governance reports.

Several national institutes in Europe are working to promote external quality assessments, using techniques appropriate to their national cultures to achieve the overall objectives. For example, IFACI, the IIA in France, has developed a certification programme in accordance with the requirements of the European Quality Standard 45011[11] and The IIA's *International Standards*. It integrates the continuous improvement mechanisms of a quality programme with annual follow-up audits and a renewal audit every three years. A successful internal audit activity receives an attestation delivered by a certification committee. The committee is composed of experts in internal auditing; including experienced chief audit executives, audit committee members, senior executive managers and other users of internal audit services. This certification process gives internal audit activities a visible endorsement of their professionalism and of the quality of their work. It represents a stamp of confidence and provides credibility to the assurance they give.

[11] *The European Standard 45011 defines the requirements that apply to any body which delivers certifications*

3. Internal auditing: an activity designed to give value

This section of the paper explains how a professional internal audit activity conducts its work in order to provide objective assurance.

3.1 The internal audit plan

All internal audit activities are derived from an internal audit plan. The internal audit plan is prepared after a comprehensive review and analysis of the organisation's activities and risks. Activities, geographical regions, special projects, business processes, or subsidiaries representing the highest risk for the organisation receive more internal audit attention than low risk areas. High-risk areas are subject to more frequent internal audits than lower ones. The internal audit plan is also an important communication tool with the board, the audit committee, executive management and the statutory auditors. It serves as a basis for performance evaluation of the internal audit activity. The internal audit plan is vital for matching internal auditing resources and projects to the needs of the organisation.

3.2 Performing the internal audit and the results of the internal audit

Internal audits are performed in a planned and organised way. They are based on solid methodology, which is transparent to the auditees. They are guided by clear audit objectives and approved work programmes.

Internal auditors gather evidence to support the conclusions that they draw and their findings. Evidence is documented in the work papers in a systematic way so that the findings can be verified at any time.

Reports and recommendations are issued in a timely fashion. The exact style and format of the reports will vary between countries and between organisations. However, internal auditors are encouraged to give an opinion on the area under review and to make their reports action-oriented, balanced, and designed to facilitate the spread of best practice in risk management and internal control.

Managers are responsible for the implementation of the recommendations and should regularly inform the chief audit executive what measures they have taken to implement the agreed actions. The chief audit executive should report to the audit committee and to senior executive management on the managers' progress. This process should be supported with frequent meetings involving the chief audit executive, management and, where appropriate, executive management and the audit committee to make sure that progress against agreed actions is properly monitored.

3.3 Types of internal audit activities

As was noted above, the scope of internal auditing covers all of an organisation's activities, without regard for internal boundaries or geographical restrictions. It encompasses the adequacy and effectiveness of governance, risk management and internal control processes in identifying and responding to all the risks facing the organisation.

The following are examples of the different types of work that internal audit may undertake:

- giving assurance to the board that the organisation's risks have been properly identified and managed in accordance with the approved risk appetite;
- reviewing the activities undertaken by management to implement the ethical policy across the whole organisation;
- giving assurance that business continuity and disaster recovery planning, including that for mission-critical information systems, is adequate given the risks facing the organisation and the risk appetite;
- giving assurance that the purchase process includes adequate controls to ensure agreed levels of competitiveness, cost savings and quality performance;
- assisting the management team in evaluating the actual return on investments over a given period of time;
- carrying out an internal audit to verify an organisation's compliance with labour laws and regulations;
- giving assurance that measures are properly designed and working effectively to address health, safety and environmental risks on industrial sites;
- verifying that all purchase and sales contracts comply with the organisation's policies;
- giving an opinion on the efficiency and effectiveness of the customer complaints process; and
- providing advice to management on the design and implementation of risk management processes.

Thus, in contrast to external audit which mainly focuses on assessing historic financial data, the scope of internal audit addresses also other matters such as operational effectiveness, ongoing detailed management information and ethical and social procedures.

The unique value that a professional internal audit activity can provide to an organisation is objective assurance on the effectiveness of the governance, risk management and internal control processes. As has been previously noted, an integral part of these processes is that management should assure itself that what it expects to be happening is happening and that it is still relevant to the risks facing the organisation. However, such assurances will contain a certain degree of unconscious bias and the most open-minded management will recognise that and will recognise the value of the assurances provided by internal audit.

Examples of the ways in which internal audit adds value to an organisation:
- the audit committee gets an independent and objective assurance on the quality of internal controls from someone other than the CEO or the CFO
- the CEO gets an independent and objective assurance on the quality of internal controls from someone other than the CFO or line managers
- the CFO gets an independent and objective assurance on the quality of internal controls from someone other than the line managers and decentralised finance staff
- the CEO and the audit committee obtain a complete overview on the risks the organisation is facing

The value provided by internal audit's objective assurance forms a major part of the quality of its performance and should be assessed and reported on as part of the external quality assessments.

3.4 Internal auditing and fraud

Fraud can occur in every organisation, in any sector of economic activity. The perpetrators may be found at all levels of the organisation. There is no guarantee that any system of control - internal or external - or any group of professional advisors will eradicate fraud.

Fraud is only one of the many risks an organisation faces. Internal audit will ensure that the risk of fraud has been properly identified and assessed by executive management. Internal audit will provide assurance that internal controls have been properly designed to address the risk of fraud and that they are working effectively. The very existence of an internal audit activity is often perceived as a deterrent to fraudulent behaviour.

An internal auditor may be expected to have enough knowledge to identify the signs that suggest that fraud might exist, often known as 'red flags', but they cannot be expected to have the same level of expertise as that of a person whose primary responsibility is detecting and investigating fraud. Regular reporting to executive management and the board on the effectiveness of internal controls, providing recommendations for improving internal controls and distributing information on the latest techniques for fraud detection can together make a significant contribution to fraud prevention.

In cases where fraud is suspected, the internal audit activity may undertake investigations, provided the specialist procedural, investigatory, analysis and evidence gathering skills are present in the department.

In addition, the internal audit activity can be seen by an organisation's staff as a secure environment for internal whistleblowers to raise concerns when it is perceived that those concerns are not being adequately addressed by line managers.

4. Internal auditing and the relations with other actors in the governance process

4.1 Relationship with the board and its audit committee

A professional internal audit activity is a major source of information to the board and its special committees. It provides assurance on the effectiveness of governance, risk management and internal control processes, covering strategic, reputational, market, credit, operational and financial risks, and can help boards prevent situations like those underlying recent governance and quality of earnings catastrophes.

The exact nature of the board's committees will vary between jurisdictions but more and more organisations are establishing audit committees, as a way of fulfilling more effectively their responsibility to demonstrate the integrity of their financial statements, risk management processes and internal controls. Such audit committees are in a position to provide extra support to ensure the effectiveness, value and independence of the internal audit activity. They also provide an efficient way to coordinate the activities of the internal auditors and the statutory auditors.

The ECIIA recommends that the audit committee should be composed solely of independent board members. They should have the skills to evaluate financial and management controls, and the ability, experience, and willingness to act for the good of the organisation and its stakeholders. They should have the time to find out enough about the organisation so that they can effectively challenge the executive management.

In order for the audit committee and the internal audit activity to be in a position to realise the potential for mutual support, certain factors need to be in place. Firstly, the respective charters of the audit committee and the internal audit activity should be complementary. Secondly, the chief audit executive should have direct access to the chair of the audit committee. There should be regular contact between the chief audit executive and the audit committee so that a relationship of mutual trust can develop. The chief audit executive has a duty to report to the audit committee when they detect wrongdoing, illegal acts or other irregularities that have either been perpetrated, or tolerated, by executive management and which are likely to jeopardize the business.

The chief audit executive should attend audit committee meetings to discuss the internal audit charter, the review of the internal audit plan, significant internal audit findings and how recommendations have been followed up. The audit committee should ensure that the internal audit activity is structured in a way that achieves organisational independence and permits full and unrestricted access to all staff and documentation, top management, the audit committee and the board.

The audit committee should report on the effectiveness of the internal audit activity, its capabilities and the results of its work when reporting to the board. They should also consider the adequacy of its budget, the quality of its resources and the planned use of external experts.

The audit committee may also facilitate and encourage communication between internal audit, executive management and the statutory auditors to

minimise duplication of work and to promote the strongest corporate governance.

4.2 Relationship with executive management

The role of internal audit is both internal and independent. Therefore, a solid and constructive relationship with executive management must exist and is critical for an effective internal audit activity. An administrative reporting line to the chief executive officer helps to reinforce the organisational status of internal audit, to include the chief audit executive in important information sharing sessions for executive management, to support its unrestricted access to staff, information and documentation and to foster the organisational independence of internal audit. A balanced relationship – neither too hostile, nor too friendly but based on mutual confidence – is in the interest of the organisation. Both executive management and the board have a responsibility in steering this process.

Executive management should commit to giving prompt responses to recommendations from internal audit, to monitoring the implementation of action plans and to keeping internal audit informed of plans, of changes to the risk and internal control profile of the organisation and of major changes to the organisation's policies and procedures.

Management is responsible for governance, risk management and internal control and should not delegate this responsibility to internal audit. However, management can obtain valuable advice and support from the internal audit activity on the best way to address the risks the organisation faces.

Whereas the internal audit activity's relationship with most of the management of the organisation retains a little distance, there is often closer cooperation between internal audit and other functions involved in risk management activities. These may include environmental inspectors, fraud investigators, risk managers, and specialists in health and safety, compliance, security and quality assurance.

4.3 Relationship with the statutory auditors

Internal audit and statutory audit have different remits. Statutory auditors have a legal obligation to report to the shareholders on the public financial statements and their focus, therefore, is on the historic financial data. However, to fulfil this obligation, they require a good understanding of the internal financial controls that lead to the preparation of the financial statements. In that respect, statutory auditing and internal auditing are complementary, and synergies exist between their activities. But overlaps or gaps in their work programmes may arise from a lack of coordination.

The *International Standards* require that the chief audit executive shares information and coordinates activities with the statutory auditors so that every aspect of the organisation is covered and there is the minimum of duplication of effort. The two parties should exchange information frequently on the scope of the audit, the audit approach and the findings. The audit committee should challenge these arrangements and assumptions. Their respective plans should be coordinated to ensure the best possible value in audit coverage while respecting the legal obligations of the statutory auditors. A regular exchange on the results of their work, like sharing the reports of internal audit, or the management letters of the statutory auditors, will

improve the synergy between these two participants in the governance process.

Internal audit and statutory audit are two key pillars of governance. Each one has to fulfil its own mission and carry out its duties properly so that the governance procedures built upon their work is robust. Therefore, external auditors should not consider the internal auditors merely as in-house resource for performing their work, but should respect the value of internal audit's particular contribution.

Although similarities exist in the responsibilities of the statutory auditors and internal auditors, it is important to highlight that in the area of risk identification and the verification of the existence and effectiveness of internal controls, the internal auditor is better placed to provide assurance to the board and the executive management because:

- internal audit has a permanent presence in the organisation and has continuous access to executive management and the board;
- internal audit can adapt its internal audit plan quickly to the changed strategic objectives of the organisation;
- internal audit can time its work to the needs of executive management or to the emergence of risks;
- internal audit's scope is much larger than just the risks and internal controls around historical financial reporting;
- internal audit can identify and measure risks associated with operations before they end up in the financial reporting of the organisation; and
- internal audit can invest time in ensuring that recommendations on risk management and internal control are actively followed-up.

4.4 Relationship with regulators

The relationship between the internal audit activity and regulators is most significant in the financial services industries because of the influence of the Basel Committee on Banking Supervision.

Market regulators have the opportunity to evaluate the work of the internal audit activity and, if satisfactory, the results of the work of internal audit can be used by the regulators to identify gaps in the internal control framework and to identify risk areas. They have the right to challenge the coordination between internal and statutory auditors and can insist on information sharing sessions between market regulators and internal auditors from the same sector on subjects of common interest.

The ECIIA believes that this practice is crucial for ensuring public confidence in the financial sector.

Appendix 1: ECIIA

The ECIIA is a confederation of national associations of internal auditing that are located in countries within the greater European economic area. This includes all of the European Union, Switzerland, Eastern Europe, Scandinavia and the Mediterranean basin. There are 30 members (representing 31 countries) and several prospective members waiting to join. There are no individual members, only IIA institutes or chapters.

The ECIIA is run by its members for its members. A delegate from each member country meets annually at the General Assembly to approve the programme of work and its funding, and to set the strategic direction of the Confederation. The Management Board has charge of the day-to-day running of the Confederation, implements the strategy and develops policies and programmes, which achieve the Confederation's goals and objectives. The Management Board meets at least four times each year.

The mission statement of the ECIIA is:

- To be the consolidated voice for the profession of internal auditing in a widely defined Europe by dealing with the European Union, its Parliament and Commission and any other European or global institutions of influence.
- To represent and develop the internal auditing profession throughout the wider geographic area of Europe and the Mediterranean basin.
- To represent the European internal auditing profession in tandem - and in consultation - with The IIA
- To promote the profession in economically emerging countries, where

appropriate, within the wider geographic area of Europe and the Mediterranean basin

The countries represented by current members are:
Azerbaijan, Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Israel, Italy, Lithuania, Luxembourg, Morocco, Netherlands, Norway, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, Switzerland, Tunisia, Turkey and United Kingdom.

Appendix 2: Code of Ethics

Introduction

The purpose of The Institute's *Code of Ethics* is to promote an ethical culture in the profession of internal auditing.

A code of ethics is necessary and appropriate for the profession of internal auditing, founded as it is on the trust placed in its objective assurance about risk management, control, and governance. The Institute's *Code of Ethics* extends beyond the definition of internal auditing to include two essential components:

1. Principles that are relevant to the profession and practice of internal auditing;
2. Rules of Conduct that describe behaviour norms expected of internal auditors. These rules are an aid to interpreting the Principles into practical applications and are intended to guide the ethical conduct of internal auditors.

The *Code of Ethics* together with The Institute's *Professional Practices Framework* and other relevant Institute pronouncements provide guidance to internal auditors serving others. " Internal auditors " refers to Institute members, recipients of or candidates for IIA professional certifications, and those who provide internal auditing services within the definition of internal auditing.

Applicability and Enforcement

This *Code of Ethics* applies to both individuals and entities that provide internal auditing services.

For Institute members and recipients of or candidates for IIA professio-

nal certifications, breaches of the *Code of Ethics* will be evaluated and administered according to The Institute's Bylaws and Administrative Guidelines. The fact that a particular conduct is not mentioned in the Rules of Conduct does not prevent it from being unacceptable or discreditable, and therefore, the member, certification holder, or candidate can be liable for disciplinary action.

Principles

Internal auditors are expected to apply and uphold the following principles:

Integrity

The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.

Objectivity

Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.

Confidentiality

Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.

Competency

Internal auditors apply the knowledge, skills, and experience needed in the performance of internal auditing services.

Rules of Conduct

1. Integrity

Internal auditors:

1.1. Shall perform their work with honesty, diligence, and responsibility.

1.2. Shall observe the law and make disclosures expected by the law and the profession.

1.3. Shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organization.

1.4. Shall respect and contribute to the legitimate and ethical objectives of the organization.

2. Objectivity

Internal auditors:

2.1. Shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationship that may be in conflict with the interests of the organization.

2.2. Shall not accept anything that may impair or be presumed to impair their professional judgment.

2.3. Shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.

3. Confidentiality

Internal auditors:

3.1. Shall be prudent in the use and protection of information acqui-

red in the course of their duties.

3.2. Shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization.

4. Competency

Internal auditors:

4.1. Shall engage only in those services for which they have the necessary knowledge, skills, and experience.

4.2. Shall perform internal auditing services in accordance with the *Standards for the Professional Practice of Internal Auditing*.

4.3. Shall continually improve their proficiency and the effectiveness and quality of their services.

Adopted by The IIA Board of Directors, June 17, 2000

Appendix 3: International Standards for Internal Auditing

INTRODUCTION

The IIA published the first international standards for internal auditing in 1978. The standards are subject to a systematic process of review and development. When internal auditors comply with these standards and the Code of Ethics reproduced above, they will deliver value to their organisations as one of the cornerstones of governance.

Reproduced below are the Attribute Standards, the Performance Standards and the Glossary as revised in 2003. The Attribute Standards address the characteristics of organisations and parties performing internal audit activities. The Performance Standards describe the nature of internal audit activities and provide quality criteria against which the performance of these services can be evaluated. The *Standards* employ terms that have been given specific meanings and these are included in the Glossary.

The full set of standards also includes the Implementation Standards, which apply to specific types of engagements.

ATTRIBUTE STANDARDS

1000 – Purpose, Authority, and Responsibility

The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the *Standards*, and approved by the board.

1100 – Independence and Objectivity

The internal audit activity should be independent, and internal auditors should be objective in performing their work.

1110 – Organizational Independence

The chief audit executive should report to a level within the organization that allows the internal audit activity to fulfil its responsibilities.

1120 – Individual Objectivity

Internal auditors should have an impartial, unbiased attitude and avoid conflicts of interest.

1130 – Impairments to Independence or Objectivity

If independence or objectivity is impaired in fact or appearance, the details of the impairment should be disclosed to appropriate parties. The nature of the disclosure will depend upon the impairment.

1200 – Proficiency and Due Professional Care

Engagements should be performed with proficiency and due professional care.

1210 – Proficiency

Internal auditors should possess the knowledge, skills, and other competencies needed to perform their individual responsibilities. The internal audit activity collectively should possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities.

1220 – Due Professional Care

Internal auditors should apply the care and skill expected of a reasonably prudent and competent internal auditor. Due professional care does not imply infallibility.

1230 – Continuing Professional Development

Internal auditors should enhance their knowledge, skills, and other competencies through continuing professional development.

1300 – Quality Assurance and Improvement Program

The chief audit executive should develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness. This program includes periodic internal and external quality assessments and ongoing internal monitoring. Each part of the program should be designed to help the internal audit activity add value and improve the organization's operations and to provide assurance that the internal audit activity is in conformity with the *Standards* and the *Code of Ethics*.

1310 – Quality Program Assessments

The internal audit activity should adopt a process to monitor and assess the overall effectiveness of the quality program. The process should include both internal and external assessments.

1311 – Internal Assessments

Internal assessments should include:

- Ongoing reviews of the performance of the internal audit activity; and
- Periodic reviews performed through self-assessment or by other persons within the organization, with knowledge of internal audit practices and the *Standards*.

1312 – External Assessments

External assessments, such as quality assurance reviews, should be conducted at least once every five years by a qualified, independent reviewer or review team from outside the organization.

1320 – Reporting on the Quality Program

The chief audit executive should communicate the results of external assessments to the board.

1330 – Use of "Conducted in Accordance with the Standards"

Internal auditors are encouraged to report that their activities are "conducted in accordance with the *International Standards for the Professional Practice of Internal Auditing*." However, internal auditors may use the statement only if assessments of the quality impro-

vement program demonstrate that the internal audit activity is in compliance with the *Standards*.

1340 – Disclosure of Non-compliance

Although the internal audit activity should achieve full compliance with the *Standards* and internal auditors with the *Code of Ethics*, there may be instances in which full compliance is not achieved. When non-compliance impacts the overall scope or operation of the internal audit activity, disclosure should be made to senior management and the board.

PERFORMANCE STANDARDS

2000 – Managing the Internal Audit Activity

The chief audit executive should effectively manage the internal audit activity to ensure it adds value to the organization.

2010 – Planning

The chief audit executive should establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organization's goals.

2020 – Communication and Approval

The chief audit executive should communicate the internal audit activity’s plans and resource requirements, including significant interim changes, to senior management and to the board for review and appro-

val. The chief audit executive should also communicate the impact of resource limitations.

2030 – Resource Management

The chief audit executive should ensure that internal audit resources are appropriate, sufficient, and effectively deployed to achieve the approved plan.

2040 – Policies and Procedures

The chief audit executive should establish policies and procedures to guide the internal audit activity.

2050 – Coordination

The chief audit executive should share information and coordinate activities with other internal and external providers of relevant assurance and consulting services to ensure proper coverage and minimize duplication of efforts.

2060 – Reporting to the Board and Senior Management

The chief audit executive should report periodically to the board and senior management on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan. Reporting should also include significant risk exposures and control issues, corporate governance issues, and other matters needed or requested by the board and senior management.

2100 – Nature of Work

The internal audit activity should evaluate and contribute to the improvement of risk management, control, and governance processes using a systematic and disciplined approach.

2110 – Risk Management

The internal audit activity should assist the organization by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems.

2120 – Control

The internal audit activity should assist the organization in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement.

2130 – Governance

The internal audit activity should assess and make appropriate recommendations for improving the governance process in its accomplishment of the following objectives:

- Promoting appropriate ethics and values within the organization.
- Ensuring effective organizational performance management and accountability.
- Effectively communicating risk and control information to appropriate areas of the organization.
- Effectively coordinating the activities of and communicating information among the board, external and internal auditors and management.

2200 – Engagement Planning

Internal auditors should develop and record a plan for each engagement, including the scope, objectives, timing and resource allocations.

2201 – Planning Considerations

In planning the engagement, internal auditors should consider:

- The objectives of the activity being reviewed and the means by which the activity controls its performance.
- The significant risks to the activity, its objectives, resources, and operations and the means by which the potential impact of risk is kept to an acceptable level.
- The adequacy and effectiveness of the activity's risk management and control systems compared to a relevant control framework or model.
- The opportunities for making significant improvements to the activity's risk management and control systems.

2210 – Engagement Objectives

Objectives should be established for each engagement.

2220 – Engagement Scope

The established scope should be sufficient to satisfy the objectives of the engagement.

2230 – Engagement Resource Allocation

Internal auditors should determine appropriate resources to achieve engagement objectives. Staffing should be based on an evaluation

of the nature and complexity of each engagement, time constraints, and available resources.

2240 – Engagement Work Program

Internal auditors should develop work programs that achieve the engagement objectives. These work programs should be recorded.

2300 – Performing the Engagement

Internal auditors should identify, analyze, evaluate, and record sufficient information to achieve the engagement's objectives.

2310 – Identifying Information

Internal auditors should identify sufficient, reliable, relevant, and useful information to achieve the engagement's objectives.

2320 – Analysis and Evaluation

Internal auditors should base conclusions and engagement results on appropriate analyses and evaluations.

2330 – Recording Information

Internal auditors should record relevant information to support the conclusions and engagement results.

2340 – Engagement Supervision

Engagements should be properly supervised to ensure objectives are achieved, quality is assured, and staff is developed.

2400 – Communicating Results

Internal auditors should communicate the engagement results.

2410 – Criteria for Communicating

Communications should include the engagement's objectives and scope as well as applicable conclusions, recommendations, and action plans.

2420 – Quality of Communications

Communications should be accurate, objective, clear, concise, constructive, complete, and timely.

2421 – Errors and Omissions

If a final communication contains a significant error or omission, the chief audit executive should communicate corrected information to all parties who received the original communication.

2430 – Engagement Disclosure of Non-compliance with the Standards

When non-compliance with the *Standards* impacts a specific engagement, communication of the results should disclose the:

- *Standard(s)* with which full compliance was not achieved,
- Reason(s) for non-compliance, and
- Impact of non-compliance on the engagement.

2440 – Disseminating Results

The chief audit executive should communicate results to the appropriate parties.

2500 – Monitoring Progress
The chief audit executive should establish and maintain a system to monitor the disposition of results communicated to management.

2600 – Resolution of Management's Acceptance of Risks
When the chief audit executive believes that senior management has accepted a level of residual risk that may be unacceptable to the organization, the chief audit executive should discuss the matter with senior management. If the decision regarding residual risk is not resolved, the chief audit executive and senior management should report the matter to the board for resolution.

STANDARDS GLOSSARY

Add Value – Value is provided by improving opportunities to achieve organizational objectives, identifying operational improvement, and/or reducing risk exposure through both assurance and consulting services.

Adequate Control – Present if management has planned and organized (designed) in a manner that provides reasonable assurance that the organization's risks have been managed effectively and that the organization's goals and objectives will be achieved efficiently and economically.

Board – A board is an organization's governing body, such as a board of directors, supervisory board, head of an agency or legislative body,

board of governors or trustees of a non profit organization, or any other designated body of the organization, including the audit committee, to whom the chief audit executive may functionally report.

Charter – The charter of the internal audit activity is a formal written document that defines the activity's purpose, authority, and responsibility. The charter should (a) establish the internal audit activity's position within the organization; (b) authorize access to records, personnel, and physical properties relevant to the performance of engagements; and (c) define the scope of internal audit activities.

Chief Audit Executive – Top position within the organization responsible for internal audit activities. Normally, this would be the internal audit director. In the case where internal audit activities are obtained from outside service providers, the chief audit executive is the person responsible for overseeing the service contract and the overall quality assurance of these activities, reporting to senior management and the board regarding internal audit activities, and follow–up of engagement results. The term also includes such titles as general auditor, chief internal auditor, and inspector general.

Code of Ethics – The Code of Ethics of The Institute of Internal Auditors (IIA) are Principles relevant to the profession and practice of internal auditing, and Rules of Conduct that describe behaviour expected of internal auditors. The Code of Ethics applies to both parties and entities that provide internal audit services. The purpose of the Code of Ethics is to promote an ethical culture in the global profession of internal auditing.

Compliance – Conformity and adherence to policies, plans, procedures, laws, regulations, contracts, or other requirements.

Conflict of Interest – Any relationship that is or appears to be not in the best interest of the organization. A conflict of interest would prejudice an individual's ability to perform his or her duties and responsibilities objectively.

Consulting Services – Advisory and related client service activities, the nature and scope of which are agreed with the client and which are intended to add value and improve an organization's governance, risk management, and control processes without the internal auditor assuming management responsibility. Examples include counsel, advice, facilitation and training.

Control – Any action taken by management, the board, and other parties to manage risk and increase the likelihood that established objectives and goals will be achieved. Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved.

Control Environment – The attitude and actions of the board and management regarding the significance of control within the organization. The control environment provides the discipline and structure for the achievement of the primary objectives of the system of internal control. The control environment includes the following elements:

- Integrity and ethical values.
- Management's philosophy and operating style.

- Organizational structure.
- Assignment of authority and responsibility.
- Human resource policies and practices.
- Competence of personnel.

Control Processes – The policies, procedures, and activities that are part of a control framework, designed to ensure that risks are contained within the risk tolerances established by the risk management process.

Fraud – Any illegal acts characterized by deceit, concealment or violation of trust. These acts are not dependent upon the application of threat of violence or of physical force. Frauds are perpetrated by parties and organizations to obtain money, property or services; to avoid payment or loss of services; or to secure personal or business advantage.

Governance – The combination of processes and structures implemented by the board in order to inform, direct, manage and monitor the activities of the organization toward the achievement of its objectives.

Independence – The freedom from conditions that threaten objectivity or the appearance of objectivity. Such threats to objectivity must be managed at the individual auditor, engagement, functional and organizational levels.

Internal Audit Activity – A department, division, team of consultants, or other practitioner(s) that provides independent, objective assurance and consulting services designed to add value and improve an organization's operations. The internal audit activity helps an organization accom-

plish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Objectivity – An unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they have an honest belief in their work product and that no significant quality compromises are made. Objectivity requires internal auditors not to subordinate their judgment on audit matters to that of others.

Risk – The possibility of an event occurring that will have an impact on the achievement of objectives. Risk is measured in terms of impact and likelihood.

Risk Management – A process to identify, assess, manage, and control potential events or situations, to provide reasonable assurance regarding the achievement of the organization's objectives.

Should – The use of the word "should" in the Standards represents a mandatory obligation.

Standard – A professional pronouncement promulgated by the Internal auditing Standards board that delineates the requirements for performing a broad range of internal audit activities, and for evaluating internal audit performance.

Appendix 4: Sources and Literature

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